Monthly Letter on

Economic Conditions Government Finance

1949

New York, July, 1949

General Business Conditions

THE business decline has continued during June at much the same rate as in earlier months. Beginning in March, the Federal Reserve Board's index of industrial production has declined five points each month, and the May figure was 174 (1935-39 = 100), compared with the peak of 195 last October and November. Preliminary data suggest that the June drop has been of about the same extent. July evidently will bring a similar decline. On the favorable side, the automobile industry is producing at the highest level in twenty years, and construction contract awards and starts continue good, especially in public work. But steel mills, which weigh heavily in the index, are reducing operations with unexpected speed. The end-June rate of ingot production was below 80 per cent of capacity against 92 at the beginning of the month. Bituminous coal will give little support to the situation in July, part-time operations are spreading in other lines, and plant vacations will add to the usual mid-Summer slackening.

CONTENTS

Only two or three months ago heads of several steel companies, at their annual meetings, offered estimates of the steel outlook. Some expected operations to hold at approximate capacity at least through the second quarter, and Mr. Weir of National Steel was considered relatively pessimistic when he stated that ingot output might drop to 75 per cent before the end of the year. It is now apparent that in steel, as in some other industries earlier, the speed with which buyers would cut back, once the downturn began, was underestimated. The lesson is that a change in conditions and in psychology spreads rapidly. Steel buyers in many cases have cancelled or deferred shipments. Like buyers of other industrial materials, they have experienced a drop in sales of their own products. They also think prices may ease and, as in other lines, they are out to shorten commitments and reduce inventories.

The Hand-to-Mouth Buying Policy

A general picture of buying policy is supplied by the National Association of Purchasing Agents, which makes a monthly survey among its members. In June 69 per cent, a new high, were buying on a hand-to-mouth to 30-day basis. In May the percentage was 62. The survey also shows that in 60 per cent of the companies reporting, inventories of purchased materials have dropped for three consecutive months or more. Half of the companies show an increased turnover, and in only one-quarter has turnover declined.

Among retail distributors the shortening of commitments has gone to equal lengths. No overall figures are available since the end of April, when a group of department stores reported stocks 3½ per cent below a year ago and outstanding orders 34 per cent lower; but there is other evidence to show that retail commitments now are relatively as short as they were then, and possibly even shorter.

This policy of meeting consumption requirements as far as possible out of inventories, reduc-

ing commitments and waiting for lower prices, furnishes the chief explanation for the speed of the recession. It is causing goods to back up in producers' hands, with resulting curtailment of production. In some quarters the caution may be overdone, for merchants who fail to stock a sufficient variety lose business and leave themselves open to a possible squeeze in supplies. However, if not abused the policy is prudent. It is accomplishing a desirable adjustment in inventory positions and holding down risks, and it will pave the way for an increase in buying, in due course, to meet consumption needs.

In many lines processors and distributors are making substantial headway in cutting inventories. The past month has brought a halt to the decline in prices of both lead scrap and copper scrap, which had dropped sharply since last Winter, and the basic reason is that less lead and copper has been moving into processing and distribution channels than has been moving out at the other end. The largest users of lead are battery manufacturers. In this Letter some time ago the low volume of replacement battery shipments was contrasted with the record-breaking use of batteries that results from having a record number of automobiles on the road, and it is plain that battery production must be stepped up sharply to supply needs for the second half year. Meanwhile battery manufacturers had cut their purchases of lead, and must now buy more. At the same time, appropriations have been made for government stockpile buying. The lead situation is firming accordingly.

We referred last month to the drop in shipments of copper, both by producers and fabricators, and to the even sharper decline in sales. Statistics for May show that producers delivered only 32,566 tons to fabricators, the smallest tonnage in eleven years, while fabricators shipped only 61,383 tons against 126,700 in the peak month last October, and sold only 40,442 tons. These figures indicate a continuing reduction in stocks outside of producers' hands, which is laying the basis for an eventual upturn in buying. The Government is also taking copper for its stockpile. Domestic production of copper has been cut some 20 per cent, and output in Chile is being curtailed.

The Textile Situation

Another industrial group in which price and inventory corrections have gone far is the textiles. The peak of cotton goods prices was reached eighteen months ago. Since then the decline on standard unfinished fabrics, according to an index compiled by the Department of Agriculture, has amounted to 36 per cent. As to mill curtailment, Mr. W. Ray Bell, president of the Associated Cotton Textile Merchants of New York, reports that production of broad woven goods exclusive of tire fabrics in the first quarter of this year was 13 per cent below a year ago. Later figures on goods are not available, but raw cotton consumption in April was down 28 per cent and in May 26 per cent. Curtailment in June, and that planned for July, appears to be even greater.

Mr. Bell points out that a drop of but 10 per cent in production this year would bring the cotton goods supply for this country down to 62 yards per capita, which is less than in any year except the depression years 1938 and 1930-35. A 20 per cent production drop would provide only about 55 yards per capita, in line with the most depressed periods of the last twenty years. This is not in accord with the standard of living and the buying power of today. As Mr. Bell sees the situation, the pipelines were filled, but are re-emptying again.

Shipments of rayon yarn and staple fiber were reduced 44 per cent from December through April but showed a small upturn in May, which may indicate that curtailment has gone far enough. Raw wool consumption in April was 48 per cent below the 1948 peak. No such declines as these have occurred in apparel sales. A seasonally adjusted index of sales of apparel stores, compiled by the Department of Commerce, was 313 in May (1935-39 = 100), compared with a peak of 342 in December and with 320 in May 1948. The drop is 8.5 per cent from the peak and only 2 per cent from a year ago, and these are dollar figures, affected by declines in prices. According to the surveys of the Bureau of Labor Statistics, retail clothing prices have dropped 4½ per cent since December, and 3 per cent since May last year.

Implications of Rapid Recession

Current business comment includes a good many expressions of alarm at the speed of the recession, and many people ask what will stop it, in view of the obvious depressing effects upon employment and buying power of the drop in industrial production. The foregoing illustrations show, however, that there is another way of looking at the matter. If the recession is speedy, so are the adjustments necessary to improvement. In the lines cited, production has dropped more than final consumption, new orders have declined more than production, and the price adjustment has been sharp. A market position is developing out of which must follow an increase in sales, along the line from the primary producer to the retailer. Even in the steel indus-

try more of the curtailment is behind and less ahead than people expected earlier, and inventory reduction is under way.

It would be too much to say that the particular cases described typify the entire industrial situation. The industries are in various stages of recession, and many are not as far along in meeting new conditions as those cited. Many will have to get prices down further, or curtail further, or both. The automobile industry will not indefinitely give as much support to employment, and to producers of materials and parts, as it is now. In heavy machinery and equipment lines operations are generally still high, but the backlog of unfilled orders is diminishing, and the support which these industries give to the economy evidently will be on a declining scale. All the industries are interdependent. Further declines in some will act as a brake upon recovery in others. Hence the precedents are against an assumption that an upswing in textiles, or a pickup in lead and copper buying that will halt the price drop and avert further curtailment, can turn a general decline abruptly into a new upward movement.

Nevertheless, the speed with which adjustments are moving may lead to a demonstration, earlier than pessimists now expect, of the recuperative powers that rest in business itself. A showing of such powers in the important areas mentioned would influence sentiment in other areas. It ought to forestall any feeling that a long and severe depression threatens.

The Role of Government

In particular, even a limited Fall recovery would supply a forceful answer to the proposals that the Federal Government should take new and drastic steps, such as deliberately undertaking vast expenditures and incurring huge deficits, to support demand.

These proposals, for public works, for enlarged payments to individuals under the general heading of welfare, and even for the construction of industrial facilities unless business builds them itself, are persistent. It is difficult to see upon what theory they can be supported, unless the proponents think the Government has both the power and the duty to keep the economy in a state of perpetual boom Otherwise deliberate intervention of this kind would hardly be suggested at a time when employment is still "full", in any reasonable definition of the term; when most signs indicate that business is going through a period of adjustment rather than a major deflationary movement feeding upon itself; and when there is encouraging likelihood that the economy may show, fairly soon, recuperative powers of its own.

The country needs a clarification of the Administration's attitude toward these proposals. If they are approved or sponsored, a new uncertainty and disturbing influence will be injected in the outlook. Enterprise and investment will be discouraged, and adjustments delayed or averted.

In the end, recovery will come about through inventory reduction, which is moving rapidly; through cost reduction, which requires increased efficiency and productivity, and which is under way; through price reduction, which will grow out of competition and cost reduction, and which also is under way; and, finally, through whatever shifting of material resources and labor from one product or occupation to another the situation requires. The wants of people change, lastingly as customs and habits change, and also temporarily as specific markets become saturated. The offerings of producers in the markets must change with people's wants, if trade is to go on and employment is to be maintained, and the distribution of labor and resources must change to the extent necessary.

To promote these fundamental adjustments the Federal Government can do little. It cannot successfully attempt to tell people what to produce, or how or where to produce it, for in a country where consumers exercise free choice only free markets can guide production The Government can spend heavily, and the spending will support demand while it lasts. But government spending contributes nothing to the solution of the problems of cost and price reduction. In the end the problems of adjustment would remain.

Shift of Federal Reserve Policy

The continued easing in business and the slackening in the demand for credit have led during the month to a change of Federal Reserve policy with respect to the government securities market, which was announced in a statement published in the press June 29. The statement read as follows:

> The Federal Open Market Committee, after consultation with the Treasury, announced today that with a view to increasing the supply of funds available in the market to meet the needs of commerce, business, and agriculture it will be the policy of the committee to direct purchases, sales, and exchanges of Government securities by the Federal Reserve Banks with primary regard to the general business and credit situation.
>
> The policy of maintaining orderly conditions in the Government security market and the confidence of investors in Government bonds will be continued.

Under present conditions the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased.

This announcement is significant, first, as a further notice that the Reserve authorities intend to see that deflationary forces are not accentuated by unavailability of credit. In this respect it supplements and strengthens the earlier easing of consumer credit regulations and stock exchange margin requirements and the reduction in member bank reserve requirements.

Second, and in the long run more important, it is significant because it marks a modification by the Reserve System of the policy, dating from war time, of pegging prices of government bonds at a fixed interest scale, and substitutes for it a flexible policy. Purchases and sales hereafter will be on a scale and at prices within the discretion of the Open Market Committee and with regard to general conditions as well as to the bond market.

This change is altogether desirable. It restores to the Reserve System the flexibility which it gave up during the war in the interest of supporting government bonds. It enhances the authority, prestige and influence of the System. It is also a major step toward restoring a greater freedom of movement in interest rates and allowing wider latitude to the Federal Reserve for influencing money and credit volume.

Fourth Round Wage Demands

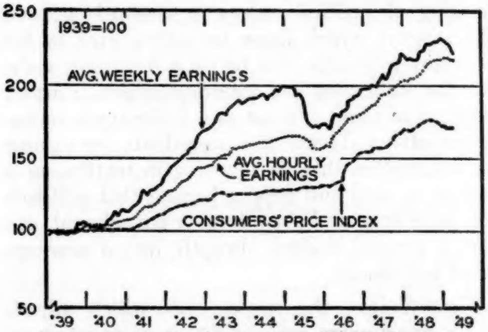
In the negotiations now under way for the renewal of labor contracts in a number of major industries, three principal arguments are advanced in support of labor's demands for a fourth round of wage increases, plus company-financed pensions, insurance, and other "fringe" benefits. These are, first, that since the end of the war the cost of living has risen more rapidly than wages, and that therefore labor has suffered hardships and injustice. Second, that industry has been making so much money that it can easily absorb further wage increases, and in addition finance company plans for expanded social security and welfare. Third, that wage increases are needed to bolster purchasing power and thus prevent further deflation and business recession.

The first two arguments are mainly questions of fact, upon which reliable information is readily available. The third argument is theory, and highly controversial theory at that. While the doctrine of the "purchasing power" school of economists — that pushing up wages automatically increases demand — has always been popular with labor for obvious reasons, it is widely disputed by other economists and by most practical business men.

Before taking up questions of theory, it would be well to get the facts straight about the first two points.

Wages vs. Cost of Living

The accompanying chart compares the changes over the war and postwar periods in average hourly earnings and average weekly earnings of factory workers, as reported by the U. S. Bureau of Labor Statistics, with the consumers' price index computed by the same Bureau.



Average Hourly Earnings, Average Weekly Earnings, and Consumers' Price Index.

It will be seen that during the war period up to the beginning of 1945, the rise in wages far outstripped the rise in the price index. This was due, on the one hand, to advances in wage rates and overtime work paid at premium rates, and, on the other, to the holding down of prices and rents by OPA controls. In terms of real purchasing power, wage earnings rose rapidly during this period to what was probably the highest level in history. Workers were able to accumulate large backlogs of savings, but the ability to make actual purchases was limited by scarcity of goods, rationing, etc.

It is true that after early 1945 wage earnings tended to lag behind living costs. Average weekly earnings slumped sharply (hourly earnings to a lesser extent) during the reconversion period, as war contracts were cancelled and production for the consumers' market was hampered by serious strikes and OPA price regulations. The rise in workers' earnings was soon resumed as the postwar boom gathered momentum and, aided by three rounds of wage increases, carried to a new peak in 1948; however, the gain compared with the 1945 high was more than offset by the rise in living costs that took place after price controls and rationing had been discontinued and the tremendous pent-up demands and purchasing power came to bear on the limited supply of goods avail-

able. Thus "real" earnings during this period lost part of their earlier gain, though compensated by the rapidly increasing availability of goods and elimination of rationing and black markets.

Taking the war and postwar period as a whole, the increase in wages over living costs was substantial, as the chart clearly shows. The following table tells the story in a nutshell. While actual hourly earnings of factory workers at the end of 1948 were up 117 per cent from 1939, and average weekly earnings were up 131 per cent, the price index rose only 72 per cent. In other words, the "real" value of hourly and weekly wages increased by 26 and 34 per cent, respectively.

Changes in Actual Wage Earnings of Factory Workers, Cost of Living, and "Real"* Wage Earnings, 1939 to December 1948

	Av. Hr. Earnings (¢)	Av. Wk. Earnings ($)	Consumers' Price Index (1939=100)	"Real"* Hourly Earnings (¢)	"Real"* Weekly Earnings ($)
1939 average	63.3	23.86	100.0	63.3	23.86
1st Quar. 1945 aver.	104.4	47.42	127.7	81.8	37.13
% Change	+ 64.9	+98.7	+27.7	+29.2	+55.6
1st Quarter 1945	104.4	47.42	127.7	81.8	37.13
December 1948	137.6	55.01	172.4	79.8	31.91
% Change	+ 31.8	+16.0	+35.0	− 2.4	−14.1
1939 average	63.3	23.86	100.0	63.3	23.86
December 1948	137.6	55.01	172.4	79.8	31.91
% Change	+117.4	+130.6	+72.4	+26.1	+33.7

* Actual dollar earnings adjusted to change in consumers' price index, to show change in real earnings in terms of purchasing power.

Naturally, labor, in campaigning for a fourth round of wage increases, is soft-pedalling these gains in buying power as compared with prewar, and stressing instead the lag in wages as compared with living costs since 1945, when wartime production was at its height and price controls and rationing were still in effect.

But this year the cost of living has been declining and in May, according to the official price index, was about 3 per cent below the peak reached last Fall. Thus the purchasing power of wages is being once more increased. While the average weekly earnings of factory workers have declined, due to elimination of overtime and to curtailed operations, this plainly is not a situation that can be corrected by increasing rates of pay unless the higher wages would result in putting more people back to full time work. This is a point that we shall discuss later on.

Corporate Ability to Pay

The second argument in support of labor's claims is based on the high earnings of business during the boom period. Labor leaders constantly inveigh against the "fabulous" profits and "rapacity" of American industry, which they assert provide ample margin for granting higher wages and other benefits without raising prices or crimping unduly funds available for essential business purposes.

The first and most obvious comment on this point is that any argument for higher wages based upon past profits has a hollow sound in view of the current trend of business and profits. For a great many businesses the good profits of last year, or even of the first quarter of this year, are ancient history. While some companies are still doing well on a backlog of accumulated orders, others are experiencing severe shrinkage in earnings, with an increasing number, particularly among smaller concerns, going into the red.

The second point about this "ability to pay" argument is that an increase in wage payments does not come out of thin air. Contrary to what is perhaps a popular impression, even great and prosperous industries do not, as a rule, keep more cash lying about than is needed for safe operating purposes. Money taken in earnings is either paid out in dividends to the shareholders, whose savings have provided the plant and equipment, or reinvested in further developing and improving the business. Hence, if wages are increased without corresponding gains in efficiency that hold down costs, the money can only come from any one, or combination of, the following sources:

1. Raising prices
2. Reducing dividends
3. Reinvesting less in the business
4. Borrowing
5. Floating more stock

A Concrete Illustration

To illustrate how wage increases influence alternative uses of funds, we show in the next table how figures for all corporations might have been affected in 1948 had wages and salaries been advanced 10 per cent without compensating increases in either efficiency of production or in selling prices. Such a calculation, of course, can only be a rough approximation because of the many complex factors involved.

All Corporations in the U. S. in 1948
(In Billions of Dollars)

	As Reported	Assuming 10% Wage Increase	Change
Corporate Wages and Salaries*	$87.0	$95.7	+8.7
Net income before taxes	32.2	23.5	—8.7
Income tax liability (38%)	12.5	9.0	—3.5
Net income after taxes	19.7	14.5	—5.2
Dividends paid	7.8	7.8	—
Income reinvested	11.9	6.7	—5.2

Source: Figures as reported represent estimates by U. S. Department of Commerce. * Corporate wages and salaries assumed at 65% of total private wages and salaries, as in previous year.

With total corporate wages and salaries estimated at approximately $87 billion last year, a

10 per cent wage increase would, assuming the same man-hours of work, have increased payrolls by \$8.7 billion to \$95.7 billion. Without a compensating increase in selling prices (which is inflationary in a boom and impracticable in a period of business contraction like the present), this would have resulted in a reduction of \$8.7 billion in net income before taxes.

The latter would have cut, to the extent of about 38 per cent or \$3.5 billion, the U. S. tax revenues, from \$12.5 to \$9.0 billion. Either the Treasury would have had to see its revenues reduced or ask people and business to pay more taxes. The cut in corporate taxes would have been offset only to a minor extent by personal taxes on the larger income from wages and salaries.

At the same time net income after taxes would have been reduced from the \$19.7 billion, as estimated by the Department of Commerce, to \$14.5 billion, or by \$5.2 billion.

As to the next question, of whether this reduction in net earnings would be taken out of dividends paid or out of income available for reinvestment in the business, the fact is that total dividend payments last year, estimated at \$7.8 billion, were but 40 per cent of total corporate net income – the lowest ratio, with the exception of 1916, in the forty-year period for which comprehensive dividend records are available. While total dividends were about double prewar, corporate wages and salaries were more than triple, and the proportion of dividends paid to total private national income dropped from 5.8 to 3.8 per cent.

When allowance is made for the decline in purchasing power of the dividend dollar, coupled with the steeply progressive personal income taxes, it can be truly said that the corporate shareholder has been "taking a beating." In view of the difficulty of selling equity issues as it is, how much could be sold were dividend returns further reduced?

Retained Earnings and Industrial Progress

If it be assumed that wages are increased, but dividend payments remain unchanged, then – other things being equal – the balance of net income available for use in the business will be reduced. In the illustration given above, based on 1948 figures, the drop would be from \$11.9 billion to \$6.7 billion.

Yet, actually, corporations used last year, for expansion and improvement of plant, and to build up working capital for handling the expanded dollar volume of business, a total of \$21.4 billion, according to studies of the Securities & Exchange Commission.

To finance this expansion, corporations secured \$7.1 billion, or about one-third, from external sources – \$5.9 billion from long-term borrowing and \$1.2 billion from sale of new stock. The remaining two-thirds of the funds required came from retained earnings and depreciation accruals. Had retained earnings been cut \$5 billion or more, corporations would either have had to cut back correspondingly their expansion and modernization program for meeting the public demand for goods and creating jobs, or would have had to get additional funds from these other sources. But borrowing was frowned upon by the authorities as inflationary, while stock issues fell upon an unreceptive market. The depreciation charges, which do not involve cash outlays, are relatively inflexible because of Treasury regulations and are actually inadequate to provide for future replacements at the higher costs now prevailing.

From the foregoing, it will be seen that this question of corporate "ability to pay" is not answered adequately by charges of "corporate greed". It is a question of what funds are available, and of which of various alternative uses of funds will, in the long run, most inure to the well-being of the people as a whole. How much do we want to divert to current consumption, and how much do we want to plow back in expanding and improving our productive equipment, lowering costs, and, through research and application of capital, developing new products and new industries that create new jobs and satisfy new wants?

Would the American people really have been better off had industry after the war utilized a larger proportion of its earnings to pay still higher wages, thus intensifying the public demand for scarce goods, instead of using this money for the increase of production which has turned scarcity into abundance?

The Purchasing Power Argument

The third argument that is advanced in support of wage increases is that they would increase purchasing power and stem deflationary tendencies. This is the constant theme of the C.I.O., and one that apparently is espoused by Leon Keyserling, vice chairman of the President's Council of Economic Advisers, who is quoted as having declared to a conference of the International Ladies' Garment Workers Union last month that –

> Business should take the initiative in putting the United States back on the road to national prosperity by stabilizing prices and increasing wages. While that might

cut into the high profits enjoyed by business in 1948, it would rebound to their benefit in the long run.

"Putting the United States back on the road to prosperity" by this prescription would be a neat trick if you could do it, but few who have ever had the responsibility for meeting a payroll could be sanguine of the outcome. The only thing that has enabled business to absorb the rapid wage increases we have had has been the tremendously high volume of business and the ability to pass higher costs on to the public in higher prices.

Now both these possibilities are "out". The public is rebelling against high prices, the volume of business is shrinking, and business is left saddled with perilously high break-even points. To increase wage costs under such conditions could have only one result — those workers lucky enough to keep their jobs would have their purchasing power increased, but many more would be forced out of jobs by factory shutdowns and find their purchasing power drastically cut.

While some concerns might be in a position to pay wage increases, all businesses are not equally well situated. The principle was stated in forthright terms by the British Chancellor of the Exchequer in the Labor Government, Sir Stafford Cripps, when, in addressing the Blackpool Conference of the Labor Party last month, he said:

> It is a mistake to think there is any easy way of turning these large undistributed profits into price reductions. They are very unevenly distributed through industries and among firms. Some do better than others for a great variety of reasons. Some firms could afford to reduce prices. Others could not as they have no surplus or need it to invest in new capital goods.

The same principle applies, of course, to wage increases.

Likewise, wage increases, exacted by monopoly pressure of strongly organized trade unions, would not apply to everyone. They would not apply to millions of people living on rigid or relatively inflexible incomes whose purchasing power has been reduced by inflation, nor to the farmers whose incomes are now declining. What these people need is lower prices for the things they have to buy.

Examples of Labor Statesmanship

Though Mr. Keyserling and the "official line" of the C.I.O. may call for wage increases to expand purchasing power, it is evident that many labor leaders take a more practical view of the situation. Thus, at the same conference of the Garment Workers Union at which Mr. Keyserling expounded his doctrine of higher wages to "put the United States back on the road to prosperity", the president of the union, David Dubinsky, told the workers that, in view of conditions, demands for wage increases had been put off in many cases, even where contracts contained "escalator" provisions calling for wage reopenings. There have been other examples of union recognition of the economic facts of life.

In contrast with the general excoriation of management so often emanating from the C.I.O. is the temperate attitude manifest by the American Federation of Labor in its official Monthly Survey for May-June. Though adhering to the general principle that "wages must move steadily upward this year to restore and increase consumer buying", the Federation nevertheless admits of certain important qualifications. Thus "wage increases should now be based on past or future increases in productivity to prevent undue rises in costs; company earning power should be considered . . . Action that would start price inflation must be avoided by government, management, and unions." The Survey goes on to say:

> In the present precarious business situation, wise union policies are of utmost importance in negotiating with your employer. Get the facts on his financial condition and outlook from him if possible, supplement your information by writing AFL Headquarters.
>
> Perhaps your employer's prospects are excellent; but if his profit margin is being squeezed by price declines your future will be more secure if you help him improve his competitive position. A wage increase may depend on a plan for union cooperation to prevent waste, save expenses, cut costs, improve production.
>
> Such a plan can be developed through a Union-Management Production Committee. Now is the time to revive this prewar idea and make it effective for today's needs.

This recognition by the American Federation of Labor of basic factors involved in wage increases is encouraging. If labor and management can sit down and work out their problems in this spirit there will be good reason to be hopeful of the outcome.

The International Currency Muddle

A correspondent from Canada writes us in part as follows:

> If a Canadian visits the U. S. and offers our Bank of Canada notes in payment of anything what happens? Probably a blunt refusal to touch the stuff, or at best a whopping discount is taken for accepting them. Even in border cities the procedure is the same and bank cashiers in such cities know, if they know anything, that our notes are as sound as any on earth.
>
> Why is this? Why are Canadians made to feel that Americans relegate them to the pauper class in monetary matters? Are Americans not aware that we are a "hard currency" country, our credit taking second place to none? That our internal financial structure is the soundest on the face of the earth including the U.S.A.?

Yes, we are an intelligent, progressive people; a bit on the conservative side, perhaps, but withal a nation eminently satisfactory to do business with, a fact which will be endorsed by your large business concerns which find Canada their best foreign market, with cash on the barrel-head for everything they sell to us.

We wonder ceaselessly why our currency is so discriminated against; and trying to reason it out on a factual basis reduces us to helpless frustration. The thing simply doesn't make sense.

Our correspondent need have no apprehensions that American businessmen do not place a high value on Canadian-American trade. It is a large trade – running at a rate of $1½ billion a year or better each way – and it is of mutual advantage as all trade soundly conceived must be. Indeed, American businessmen could sell even more goods in Canada if it were not for the fact that the Canadian Government – through a system of import and foreign exchange controls – restricts the amount that is permitted to come in. These regulations, sharply tightened in 1947, lately have been relaxed and American business looks forward to the time when they can be completely abolished. At the same time far-sighted Americans welcome enlarged imports from Canada which can provide the wherewithal for Canada to buy more here.

Why the Canadian dollar is "so discriminated against" – which so mystifies our correspondent – is very simple, although it would be more proper to say "discriminated between". To an American, there are two different kinds of Canadian dollars – "official" dollars and "free" dollars. "Official" Canadian dollars are equal in value to U. S. dollars and have been since the "upvaluation" of 1946. The Canadian Government, through its Foreign Exchange Control Board and Bank of Canada, stands back of them and guarantees to the foreign holder convertibility into U. S. dollars at par.

"Free" Canadian dollars, held by Americans, have no guarantee of value or convertibility from the Canadian Government. On the other hand, the Canadian authorities offer no objection to the transfer of the "free" dollars among Americans and have rules under which they can be brought back and used in Canada. This gives them substantial value. The discount – now 4 or 5 cents in the New York market – is determined by supply and demand without any responsibility on the part of any government for the price at which they sell.

Canadian Exchange Controls

Basically, the discount on Canadian dollars, and the need for exchange controls, are twin indications that the Canadian dollar – in the economic parlance – is slightly overvalued at its official parity with the U. S. dollar. Canadians want to spend in U. S. dollars, for purchases of U. S. goods and services, more than they can earn in U. S. dollars by selling us Canadian goods and services.

If the Canadian Government did not interfere, the official gold and dollar reserves might be drained away and control of the rate lost entirely. What the Canadian Government does is to tell their people for what purposes they can have U. S. dollars and for what purposes they cannot.

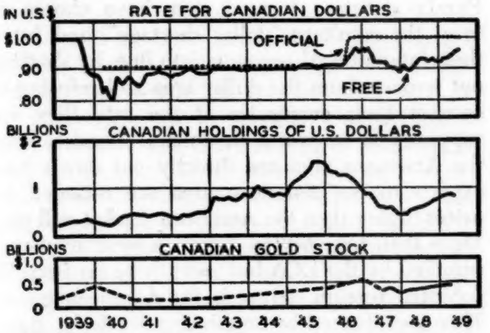
Travel to the United States is tightly restricted. A Canadian visitor can get $150 in U. S. money, with the approval of the Exchange Control Board, for travel expenses in the United States. He is not supposed to take Canadian dollars out of Canada, for sale in the United States, nor otherwise to engage in exchange transactions with his Canadian money. Our correspondent's hypothetical visitor to the United States, who presents Canadian money to an American bank cashier, thus would not be abiding by the regulations of his country.

The bank cashier, on his part, cannot fill up his vaults with Canadian paper money and stay in business. Neither he nor his depositors can use them to discharge their lawful obligations, which are undertaken in U. S. money. They are "free" Canadian dollars and there is nowhere the bank cashier can go and get U. S. money for them on a dollar for dollar basis.

The Background

Restrictions on the convertibility of Canadian dollars date back to the outbreak of the war. As the accompanying chart shows, the currency was allowed to decline from 100 cents (U.S.) to as low as 80 cents in 1940. In the same year a rate of exchange for officially approved transactions was set at 91 cents while other transactions were settled at fluctuating rates in the free market. In July, 1946, the Canadian authorities, after relaxing their import and exchange restrictions, "upvalued" the "official" rate back to parity and the "free" rate rose sympathetically in anticipation of a withdrawal of all restrictions. Evidently, however, the authorities underestimated the strength of the Canadian demand for American goods, which the upvaluation cheapened in price. Canadian reserves of gold and dollars, which had risen substantially during the later war years, were drained away until, in November, 1947, the authorities radically tightened up their exchange restrictions and cut down imports from the United States. The free rate, reflecting

these untoward developments, dropped to around 90 cents.



Canadian Exchange Rates, Dollar Holdings and Gold Stock. Sources: Federal Reserve Bulletin; International Monetary Statistics.

Since the close of 1947 the Canadian exchange position has improved markedly, though the authorities have been proceeding with due caution in easing import and exchange restrictions. The improvement has been a product of many interacting factors — the availability of ECA dollars for financing European imports from Canada, moderation in the programming of government expenditures, a consistently overbalanced government budget, subsidy payments to gold miners, a succession of tax reductions and other stimulants to domestic enterprise, encouragements to foreign capital, a $150 million loan by American insurance companies, the attractiveness of Canada to American vacationers, and rich new oil discoveries in Alberta. Canadian deposit and U. S. dollar balances with American banks are reported by the Federal Reserve Board at $870 million at the end of March, 1949, against $410 million on December 31, 1947. Practically all of this increase came in official dollar reserves. Over the same 15-month period the Canadian gold stock, which is concentrated in the Foreign Exchange Control Board, increased by $121 million to $415 million.

"Hard" Currencies Today

The world has never been so full of inconvertible paper money issues as it is today. Nowhere is gold convertibility honored for the private citizen and the term "hard" money is a carryover from bygone days when the gold sovereign ruled the seas of international trade and provided the benchmark for the valuation of other currencies. Since sterling has gone "soft" the U. S. dollar and the Swiss franc have become the standards of comparison. These two currencies, while not convertible into gold for the private citizen, are backed by large gold reserves which are used, in transactions between central banks, to defend their international purchasing power.

Internal buying power — the price level — is also a vital element in the "hardness" of a currency. In the world markets today, American prices are comparatively low — and they are free market prices at which almost any quantity can be bought. Thus the United States is a good market in which to buy and a hard market in which to compete for sales — price and quality considered.

To Europeans, Canada is also a place where prices are comparatively low and the Canadian dollar is classed with the U. S. dollar and the Swiss franc as a "hard" currency. Canadian exchange controls, as those things go, are mild, and the discount on the "free" Canadian dollar is small.

The best gauge of the "softness" — or degree of overvaluation — of a currency is found in the height of the internal price level, the rigor of the exchange and import controls necessary to limit demands on the official gold and dollar reserves, the smallness of those reserves where they are disclosed to the public, the difficulties encountered by traders attempting to do business at the official rate of exchange, and discounts on the currency in free markets outside the country concerned.

Multiple Currencies

To the average American, as to our correspondent, it "doesn't make sense" to have some Canadian dollars worth 100 U. S. cents and others worth but 95 cents. Much less does it make sense to observe, circulating in the world, thirty-odd kinds of pounds sterling, only one of which is freely convertible into U. S. dollars at the official parity of $4.03. Indeed, it is an unusual country today that, like the United States, and Cuba and Mexico to the South, has only one kind of dollar, pound or peso. These strange things are a product of exchange controls — of efforts to protect the national currency reserves, to discriminate between various holders and uses of a currency, to bottle up capital that wants to leave the country, to postpone or avoid the necessity for currency revaluation. Generally the exchange controllers forbid free trading among the different kinds of currency at home. This is a way of suppressing the fact that all units of the national currency are not maintained on a parity with one another. But differentials show up in foreign centers, beyond the range of authority or influence of the exchange control, and thus we have, in some of the most out-of-the-way places on the globe, mushrooming gold and foreign exchange markets.

Nothing like this ever could have happened under the old gold or gold exchange standard. Every unit of a nation's currency was just as good as any other, at home or abroad, and equally exchangeable into gold at the option of the holder. Arbitragers in London, New York, and other key financial centers, kept the exchange rates in line. A government had nothing to do except freely buy and sell gold, sterling, or dollars at established rates, or allow private banks to do so. In most countries this job was done by a central bank operating in conjunction with the foreign exchange market.

Epidemic Dollar Shortage

The present muddle is nothing that anyone planned in advance. No one has reduced to fully practical terms the scheme the experts at Bretton Woods endorsed five years ago when they wrote the Articles of Agreement for the International Monetary Fund. The late Lord Keynes once called the proposed new monetary order the "opposite of the gold standard." And from the standpoint of convenience to trade and travel, unhappily, it has worked out just that way.

Nevertheless, the theory at Bretton Woods held out great promise. While dealings in gold would be permitted only under government license, each currency would be readily convertible into any other for the purpose of facilitating trade on a multilateral basis. Gold and gold-backed currencies were to be held as reserve, with drawing rights on the International Fund as an extra buffer. By its statutes, the Fund was to oppose "foreign exchange restrictions which hamper the growth of world trade" as well as "competitive exchange alterations." Changes in exchange rates were to be considered, but only "to correct a fundamental disequilibrium." Exchange controls were to be used only to meet "a large or sustained outflow of capital" or a "general scarcity of a particular currency"

The apprehensions of the Bretton Woods experts over competitive exchange depreciation have proved groundless. Instead, exchange controls are being used more widely than ever before — justified always in the name of "dollar shortage." Barter trading between governments has displaced multilateral trading among individuals.

The broad pattern has been that too many countries — by overambitious capital development programs, unbalanced budgets, "easy money" policies, and inadequate incentives to production — have developed, or worsened, "fundamental disequilibrium" in their balances of trade, notably with the dollar area. They have been unexpectedly reluctant to invoke exchange rate adjustments, fully justifiable under the Fund's statutes. Instead they have chosen to meet the resultant "dollar shortage", and bring their international accounts into line, by shutting out imports from the dollar area and refusing to convert their currencies at the rate they are supposed to be worth in dollars. Imports from the American area are directly cut down; and exports to the American area are retarded by prices higher than the American market will pay. More than four billion dollars a year are being supplied by the ECA but even these far from fill potential foreign demands for American goods. This is evidenced by continuing needs for rigorous import and exchange controls. American tourist expenditures abroad are discouraged by high prices while American capital is repelled by high costs in the local currency and hazards of being locked in by exchange controls.

To be "short of dollars" is no phenomenon peculiarly reserved to foreign treasuries and central banks. As Professor Howard Ellis of the University of California stated a year ago, in an address in Vancouver, "most mortal creatures" have experienced in their personal affairs "both a dollar crisis and a chronic shortage of dollars." The reasons why foreign treasuries and central banks are "short of dollars" are, however, special. They are in the position of a bank which, having overextended itself, is short of reserves. The overextension takes the typical form of government paper money which, issued in excess, exerts upward pressures on prices, swells demands for imports, and drains away reserves to a point where exchange controls are invoked in tacit recognition of insolvency.

It is hardly an accident that "dollar shortages" are most acute where, without exchange rate adjustments, inflation of internal purchasing power has been greatest and most persistent. It is also significant that the three countries which *upvalued* their currencies in terms of the dollar — Canada and Sweden in 1946 and New Zealand in 1948 — all subsequently had to strengthen their barriers against imports from the American area. On the other hand, devaluations have been unsuccessful, and quite naturally, where internal inflation has proceeded apace. Here China and Greece are the extreme examples. Belgium and Italy, by combinations of measures, including currency adjustments and a credit squeeze, have had perhaps the largest success in balancing up their international accounts. These countries, nevertheless, still need exchange controls because they are long on inconvertible sterling and short on dollars. Close students of

the subject believe that the sterling-dollar rate of $4.03 is the crux of the problem.

Ways Out

The world economy has found it easier to get into this muddle than it may be to get out. One way out would be another wide turn of the price-wage spiral in the United States which would enable inflation here to catch up to inflation overseas. This would work new hardships on our people of limited fixed incomes. And it may be recalled that the American price rise from 1945 to 1948 was more criticized than applauded overseas. The result of a new rise might only be to precipitate a fresh wave of inflationary disturbances all over the world. It is hard to stabilize on the tail of a kite.

A second way is deflation of wages and prices in soft currency countries to a point where their international trade would balance out. This, the gold standard treatment, involves the pains of numerous business failures and temporary unemployment for many people. The best thing that can be said for it is that it works. In extreme cases it is the only salvation. And almost *nothing* will work unless, as a minimum, inflation is taken in hand, "easy money" policies eschewed, and government expenditures put through the wringer. This has been the common lesson of postwar European experience.

Third is the readjustment of official exchange rates. This permits exporters in "soft" currency countries, without having to deflate prices and wages in their own money, to compete more effectively in "hard" currency areas. In the modern economics this was supposed to be the "easy" and painless way out of exchange difficulties. Where internal inflation has gone far out of hand it is an essential supplement to other measures.

The British Position: Pros and Cons

Curiously, Great Britain, which successfully used a fluctuating pound from 1931 to 1939, and at Bretton Woods pressed most vigorously for freedom to alter the value of the pound, now disclaims with equal vigor any intention of using this device to help rectify her adverse trade position. Instead, reliance is placed, apart from American grants and loans under ECA, upon austerity, "disinflation" and deprivations by plan – upon stringent taxation, tight exchange controls, and drives to hold down wages, to urge people to tighten the belt and at the same time work harder.

The official British opposition to revaluing the pound, or allowing it to seek its own level, calls attention to the fact that adjustments in currency values are not without important disadvantages. Inevitably, with any change in a major currency, there are matters of international political prestige to be considered. The pressure of internal deflationary policies would be weakened. More closely to the point, it is recognized that devaluation of a currency increases the cost of imports, in terms of the local currency, and decreases the gold or dollar earnings from a given physical quantity of exports. These things, unfortunately, are outside the realm of exact science, and no one can be sure of results, in any particular case, beforehand.

The elasticity of demand for exports is important. If a decrease in an exchange rate – a cut in prices to foreigners – does not result in any increase in sales it has little to recommend it. But this would only happen if a particular country had a near monopoly on the products that it exports. Such monopolies, fortunately for the consumer, are few. And overplaying a monopoly position, thus stimulating substitution, can do permanent damage to export markets. In today's environment, price reductions are often necessary simply to avoid or limit a loss in physical volume of business. Tourist travel, it is broadly agreed, is highly responsive to a drop in the rate of exchange.

On the side of imports, currency devaluation does not alter the cost in dollars of a given physical volume. It does increase the cost in terms of the local currency. Here the apprehension frequently expressed is that demands for increased wages would be precipitated, and the advantages of the devaluation to exporters might be dissipated in increased manufacturing costs. Such an outcome would be unfortunate. And devaluation has little merit, outside the stimulation to export industries, unless exchange restrictions are eased and supplies of imported goods increased. Thus, if some prices rose, there could be compensation to the citizen in the freer use he could make of the money he earns.

Such is the problem that the British face. Having chosen the path of austerity and regulation, they have been carrying through with courage and discipline. In typically British fashion, they are assessing their problem, in public discussions, in the daily press, and through the *Economist* and other journals of informed opinion. All this gives the observer hope that, in one way or another, a workable solution can be achieved.

Printed in U. S. A.